P.O. BOX 655
SHARON, PA
16146
(724) 346-0150

EVANS AND ASSOCIATES
VALUATION ADVISORY SERVICES

The Business Value Manager

Advice for business owners, investors and service providers on how to build value and wealth through investment in closely held companies.

Executive Summary—Page 2

Is Your Private Company's Return On Investment Adequate?

How to Correctly Measure and Significantly Improve ROI

Most private company owners are uninformed, or even worse, misinformed about their return on investment (ROI). As a result, they frequently make poor investment choices, take unnecessary risks and fail to build long-term private company wealth.

Many ROI-related mistakes—ranging from operating decisions to making investments or acquisitions—can be avoided through a basic understanding of the unique ROI mechanics of a private company. This edition of *The Business Value Manager* is a primer on how to measure private company ROI.

How to Correctly Measure ROI

For private company owners to set appropriate return on investment goals, and measure investment performance in achieving those goals, they must have precise information about four key ROI metrics:

1. Investment
2. Return
3. Rate of Return
4. Value

These are seldom measured correctly for private company decision making, and owners seldom even have the right information to make informed decisions.

"Many ROI-related mistakes–ranging from operating decisions to making investments or acquisitions– can be avoided through a basic understanding of the unique ROI mechanics of a private company."

Investment

Which of the following constitutes the correct measure of your investment in your private company?

◊ The initial investment you and other shareholders made in the company plus any subsequent investments

◊ Your investments in the company plus any profits re-invested (this would be the book value of equity on your balance sheet)

◊ The current market value of all the tangible assets that you use in the operations of your business

The first two answers presented above are clearly incorrect, although they are frequently used in return on capital employed (ROCE) measurements. Those numbers

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represent costs incurred in the past that may or may not have any relationship to value today. If these investments are low relative to value today, they generate a higher ROI; if they are high relative to value today, they generate a lower ROI. In either case, past investments are irrelevant (they are a sunk cost) because *the key measure for current decisions is your investment value today*.

The third choice listed above, the current value of the tangible assets used in your operations, is appropriate if your company generates inadequate profits and no intangible value. *In an underperforming company with no intangible or goodwill value, your investment consists primarily of the current value of the company's tangible assets*. From our experience working in the middle market, over half of the private companies we see fail to generate adequate profits and intangible value.

An underperforming business is generally worth little or no more to its current owners than its tangible asset value, even though it may have valuable customers or technology and a good reputation. Because it fails to convert these qualities into adequate profits, they create no intangible value for the current owners unless they are sold to a buyer at a premium price that reflects intangible value that buyer hopes to create.

If your business generates sufficient profits to create operating or goodwill value—that is, if you generate profits beyond your required rate of return—your company possesses intangible value and your investment must be measured differently. *For companies that generate profits in excess of their cost of capital, the owner's investment in the business is the present value of the company's anticipated future returns* and the higher those anticipated returns are, the higher the owner's investment will be.

EXECUTIVE SUMMARY

When private company owners and executives understand the proper way to calculate ROI—using numbers not shown on traditional financial statements—they greatly enhance their likelihood to achieve an adequate ROI for their business.

The critical mechanics are investment, return, rate of return and value. This issue of *The Business Value Manager* is a primer on how to use them correctly, and how effective use of debt financing can improve ROI.

For example, consider Microsoft. Its value today has nothing to do with what people put into the company some years ago, or the profits it re-invested, or whatever its tangible assets are worth. The value of Microsoft stock trading in the market today is solely a function of the future anticipated returns—dividends and stock appreciation—that shareholders expect to receive. This traditional model we use to value public companies is the same one that should be used in valuing profitable private companies.

To summarize, as you consider your investment in your private company, that investment is either limited to the current market value of the tangible assets in the business, if it incurs losses or if its profits are inadequate, or the investment is the present value of your future returns if the company's operations generate intangible value. For profitable companies, this investment measure is harder to compute, but it is an invaluable tool for owners making investment decisions.

Return

Think of an investment you have made in a public company and what return you get from that investment. Obviously, it is limited to dividends and appreciation in the stock value. As an investor, you don't get the company's income, or its EBIT or EBITDA. If the company borrows money effectively, the returns to investors include any benefits created by this lower cost debt financing.

Private company returns must be measured the same way. The return that an investor in a private company should focus on is the spendable cash that the company generates after allowing for payment of all expenses and taxes and all reinvestment requirements for working capital and capital expenditures. This amount, which is sometimes called free cash flow, is the net cash flow on the capital invested in the business. It is computed as follows:

Net Cash Flow to Invested Capital	
	Net Income After Taxes
Add:	Interest expense, net of income tax
Add:	Noncash charges—depreciation and amortization
Less:	Capital expenditures
Less:	Increased investment in working capital
=	**Net Cash Flow to Invested Capital**

(Continued from page 2)

Curiously, net cash flow to invested capital appears on no financial statements and private company owners almost never see it. But it represents the critical cash that can be taken from the business by debt and equity capital providers after all of the company's needs have been met. It is the capital providers' true return.

"…net cash flow to invested capital appears on no financial statements and private company owners almost never see it, but it is the capital providers' true return."

Note that in providing this explanation, we are using the return to debt and equity capital providers. This is necessary because the equity in a business benefits from the availability of debt capital and appropriate use of debt can improve return on equity. *Therefore, the proper computation of "return" for strategic planning and value creation purposes should be the net cash flow return to debt and equity capital rather than just equity capital.*

Rate of Return

The third critical metric for ROI, rate of return, must be understood because every investment carries a different level of risk. Proper investment choices must consider the risk or likelihood that the investment's future return will be achieved. This rate of return is also known as a cost of capital, a required rate of return, or a discount rate, and it is used to quantify the likelihood that future returns will be achieved. Fundamental investment theory states that investors will only accept higher risk in investments if they have an opportunity to earn a higher return. Therefore, the higher the perceived risk in an investment, the higher the rate of return must be on that investment. Mathematically, higher rates of return cause greater discounting of anticipated future returns, which reduces their value. Thus, the greater the risk, the greater the discount rate and the lower the value. Conversely, lower risk would carry a lower discount rate and a higher value.

Note the distinction between your company's *required* rate of return, which reflects its relative level of risk, and your company's *actual* rate of return which reflects your historical performance. Your actual return may be above or below what you should be earning based on your investment's risk. The required rate of return is the benchmark you must achieve to create value. Because companies employ both debt capital and equity capital—and hybrids such as preferred stock or convertible debt—the cost of each of these capital sources must be computed. Some companies can take on more lower cost debt because they have greater collateral or more reliable returns that enable creditors to lend more money. The relative amounts of debt and equity vary by company and by industry and affect the company's cost of capital. The quality of management, level of competition and other competitive factors also affect the likelihood that a company will achieve a forecasted revenue, income and cash flow and all of these factors also affect its cost of capital. A private company's weighted average cost of debt and equity capital—its weighted average cost of capital (WACC)–probably varies from about 10% to 20% depending on the company's risk profile. This risk profile is quantified through an analysis of the economy, industry and company to assess its overall competitive position and likelihood of success. This process yields the company's rate of return or WACC, which is used to discount its future returns to compute its present value.

(Continued on page 4)

Recognize the Limitations of Valuation Multiples

An alternative way to express risk, and to determine the resulting value, is through use of a multiple of operating performance. The most common multiples are applied to revenue, EBITDA or EBIT. While simple to use, these multiples can and usually do distort value for several reasons:

- They are a combined measure of the company's risk and its future growth potential, and they fail to clearly measure each of these distinct parameters.
- They are applied to gross measures of return that investors do not receive. Investor's real returns—net cash flow—are far less than revenue, EBIT or EBITDA.
- They reflect the performance of the company for a single period—often its latest fiscal year—which may not reflect its long-term future potential.
- Multiples are notoriously unreliable, and are often based on the price paid in a single transaction or a few transaction that may not remotely reflect current market conditions or the risk profile of the subject company.
- Multiples ignore value reflected only on a company's balance sheet, such as a surplus or a deficiency in assets.

The conclusion here should be clear: Be very cautious of values based on multiples.

(Continued from page 3)

Just as the current measure of the first two ROI metrics- investment and net cash flow to invested capital- require careful calculation, so does the estimate of the company's rate of return. But without this precise measure of risk, the return on future investments cannot be accurately quantified.

Value

Value is a dangerous term because if it is not properly defined, it can easily be misinterpreted and this lack of precision can yield bad investment decisions.

Based on the prior discussion, it should be clear that investment in– and the value of—a private company can be computed as the greater of the current value of its tangible operating assets (if it generates inadequate returns), or the present value of its future returns discounted at a rate of return that reflects their relative level of risk. For an adequately profitable company, the present value of its future returns will exceed the tangible value of its operating assets with the excess representing the company's operating or intangible (sometimes called goodwill) value. This is the value of the business in the hands of its present owners, or to a financial buyer who would only bring cash to a deal to acquire the company. It is the company's *fair market value,* and it represents the owners' current investment in the business.

Investors should understand that same company may have a higher *strategic value*– perhaps significantly higher—to a strategic investor who, in buying the company, could create higher returns, a lower capital investment, or lower risk through their acquisition and ownership. Wise investors never lose sight of the fact that an alternative to continued ownership of their private company is sale of it to a strategic buyer who could create synergies and value enhancement and that through a sale, the seller often can share in these synergistic benefits.

In addition to the distinction between fair market value and strategic value, investors should also focus on the distinction between the value of their company as a whole– 100% of it– and the value of a fractional interest in it.

"Wise investors never lose sight of the fact that an alternative to continued ownership of their private company is sale of it to a strategic buyer who can create synergies and value enhancement."

An investment in most public companies can be liquidated in a few days because those shares are traded on an active market. For most private company investments, this is not the case unless the private company owner owns 100% of the business and it is in an industry where purchases and sales of companies frequently occur.

Those who own a minority or lack of control interest in a private company must recognize that their lack of control of the company's operations, combined with the lack of a ready market for the company's stock, renders their investment relatively less attractive. *Lack of control and the accompanying lack of marketability can diminish value by 30% to 50% or even more of the proportionate share of the value of the company as a whole.* Thus, a further step that private company owners must take in assessing their individual return on investment is to consider any diminution in value that occurs from lack of control and lack of marketability. Investors who ignore these factors in planning an exit strategy for their private company investments are frequently disappointed as they learn of the weaknesses in the bargaining position of a minority shareholder in a private company.

Illustration of Correct ROI Calculation

The data that follows in Exhibits 1 through 5 illustrate how to correctly compute net cash flow, weighted average cost of capital, investment, value and ROI for companies A and B, and Exhibit 6 presents the three fundamental ways to improve ROI.

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Illustration of Correct Computation of Private Company ROI

The following data pertains to two private companies, A and B. Shareholders of each company invested $1 million to buy their stock. Both had a market value of tangible invested capital (net operating assets) of $10 million on their balance sheets, as shown below in Exhibit 1. Companies A and B had similar risk profiles, so both had the same weighted average cost of capital (WACC) capitalization rate of 10%, as computed in Exhibit 3. Company A's *forecasted* net cash flow to invested capital was $.7 million, while Company B's was $1.2 million, as shown in Exhibit 2, and both of these returns were expected to grow for the long-term, annually at 6%. The companies' *actual* net cash flow returns for the current year were $750 for A and $1,100 for B.

EXHIBIT 1
Balance Sheet—Beginning of Current Year

Companies A & B	Book Value (000)	Market Value (000)	*Companies A & B*	Book Value (000)	Market Value (000)
Cash	1,000	1,000	**Accts Payable**	2,000	2,000
Accts Receivable	2,000	2,000	**Notes Payable**	6,000	6,000
Inventory	3,000	3,000	**Total Liabilities**	8,000	8,000
Fixed Assets (net)	4,000	6,000	**Total Equity**	2,000	4,000
Total Assets	10,000	12,000	**Total Liab & Equ**	10,000	12,000
Less: Accts Pay	(2,000)	(2,000)	**Less: Accts Pay**	(2,000)	(2,000)
Net Oper Assets	**$8,000**	**$10,000**	**Invested Capital**	**$8,000**	**$10,000**

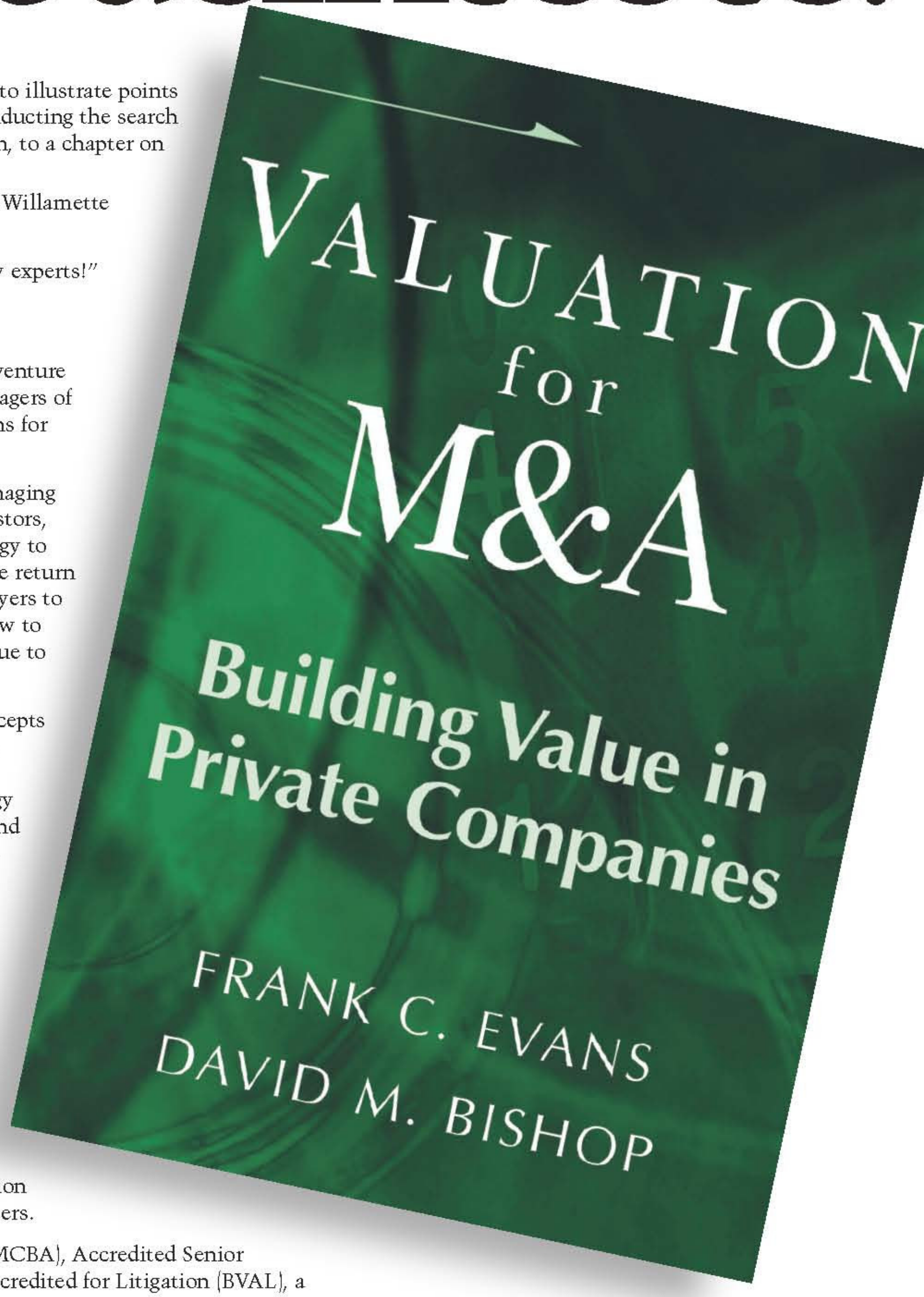
EXHIBIT 2
Forecasted Net Cash Flow for Current Year

	Company A (000)	Company B (000)
EBITDA	2,700	3,300
Depreciation	(700)	(700)
Interest	(400)	(600)
Income Tax	(600)	(800)
Net Income	1,000	1,200
Add: Net Interest Expense	200	300
Add: Depreciation	700	700
Less: Cap. Expend.	(900)	(800)
Less: Work. Capital	(300)	(200)
Net Cash Flow I/C	**700**	**1,200**

EXHIBIT 3
Weighted Average Cost of Capital

Capital Source	After Tax Cost	Weight	Weighted Average Cost
Debt	4%	40%	1.6%
Equity	24%	60%	14.4%
WACC Discount Rate			16.0%
Less: Long-term Growth Rate			-6%
WACC Capitalization Rate			10%

Building value in private businesses.



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Written for business appraisers, CPAs, investment bankers, venture capitalists, and consultants, as well as for investors and managers of non-publicly traded entities, this book is a toolkit of solutions for valuation and return on investment questions.

Valuation for M&A lays out the steps for measuring and managing value creation in nonpublicly traded entities, and helps investors, executives, and their advisors determine the optimum strategy to enhance both market value and strategic value and maximize return on investment. It provides a detailed guide for sellers and buyers to prepare for the sale and acquisition of a firm, spelling out how to identify, quantify, and qualify the synergies that increase value to strategic buyers.

Complete with a comprehensive case study to illustrate concepts and calculations, *Valuation for M&A* fills a gap that has long stymied both sides of the M&A equation, handing owners, managers, and strategic buyers the first effective methodology for measuring and building the value of a private company and ensuring that everyone gains the maximum benefit from the deals they make.

FRANK C. EVANS, a principal in Evans and Associates, Valuation Advisory Services, is a Certified Business Appraiser, an Accredited Senior Appraiser in Business Valuation, and a Certified Public Accountant/Accredited in Business Valuation. He works with middle market through Fortune 100 companies and has spoken at valuation seminars and conferences throughout North America and Europe. He has served as editor of Business Appraisal Practice, published by the Institute of Business Appraisers, and has authored numerous articles. He is the recipient of several prestigious awards, including admission to the College of Fellows of the Institute of Business Appraisers.

DAVID M. BISHOP, a Master Certified Business Appraiser (MCBA), Accredited Senior Appraiser in Business Valuation (ASA), Business Valuator Accredited for Litigation (BVAL), a charter member of the College of Fellows of The Institute of Business Appraisers, was the founder of the American Business Appraisers National Network. He is one of America's best-known writers and speakers on the valuation of businesses for M&A, value enhancement, and tax-related valuations; his practice concentrates on these types of assignments.

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EXHIBIT 4
Calculation of Investment (and Value) as of the Beginning of the Current Year

		Company A and B
Fair Market Value of Net Tangible Assets from Balance Sheet		$10,000,000
		Company A
Present Value of Forecasted Net Cash Flows	$700,000 / 10%	= $7,000,000
		Company B
Present Value of Forecasted Net Cash Flows	$1,200,000 / 10%	= $12,000,000

Conclusion: While inadequate net cash flow returns prevent Company A's operating value from exceeding the $10 million current value of its net tangible assets, the value of Company B is $12 million based on its cost of capital, anticipated profits, cash flow, and growth. These are the key measures of "investment" that shareholders should consider. The shareholders' original investment of $1 million, and the current book value of equity and invested capital are irrelevant in computing investment and ROI.

EXHIBIT 5
Calculation of ROI for Current Year for Company A and B

Based on each company's actual performance in the current year, and their competitive position at year-end, Company A is expected to earn $900 next year and Company B is expected to earn $1300, with both earnings expected to grow at 6% for the long-term. Each company had net tangible assets worth $10.5 million at year-end. While Company A's risk profile remains at 16% at year-end, Company B has strengthened its management and its balance sheet which reduced its risk and cost of capital from 16% to 15%. Using this information, the value of each company at year-end is computed as follows:

Company A		Company B	
$900,000 / (16% - 6%)	= $9,000,000	$1,300,000 / (15% -6%)	= $14,400,000

The total return to debt and equity capital providers for the current year is then computed as follows:

	Company A	Company B
Value of Investment at the End of the Year	$10,500,000	$14,400,000
Value of the Investment at the Beginning of the Year	$10,000,000	$12,000,000
Invested Capital Appreciation	$ 500,000	$ 2,400,000
Add: Actual Net Cash Flow for Current Year	$750,000	$1,100,000
Total Return for Current Year	$1,250,000	$3,500,000

Each company's return on invested capital for the current year is computed as follows:

	Company A		Company B	
Total Return for Current Year	$ 1,250,000	= 12.5%	$ 3,500,000	= 29.2%
Value of Investment at Beginning of Year	$10,000,000		$12,000,000	

In the illustration presented in this article, the computation of ROI includes capital appreciation , which is based on each company's risk profile and expected performance at year-end, as well as the net cash flow return for that year.
Can the calculation of ROI be considered reliable when one of its two major components is based on an estimate of future performance?
The estimated performance must be based on sound, objective judgment for the ROI conclusion to be credible. The ROI of public companies, however, also includes capital appreciation based on anticipated performance, so the process presented is the standard method used for public companies. Because building value is a financial objective in every company, capital appreciation must be considered to accurately compute ROI.

(Continued from Page 4)

EXHIBIT 6
Illustration of Operating Options to Enhance ROI

Building Private Company Value

Once the mechanics of private company ROI are understood, the next step is to devise a strategy to improve the company's ROI. The key factors in ROI should now be clear: * Investment (current value) * Return (net cash flow) * Rate of Return (risk)

Option 1—Reduce the investment in net operating assets employed without causing returns to decrease or risk to increase. Illustration: Through more frequent inventory turns, reduce the required investment in inventory from a market value of $3 million to $2.5 million, and pay out the $.5 million to shareholders. The Company's net cash flow and value remain the same, it requires less capital investment to generate that cash flow, and shareholders receive an added return.	*Option 2*—Increase forecasted net cash flow returns without increasing the investment in the Company or its risk. Illustration: Through improved advertising, increase net cash flow by $100,000, which when capitalized at 10%, yields $1 million in increased Company value.	*Option 3*—Decrease the Company's risk without increasing shareholder investment or impairing net cash flow returns. Illustration: By introducing a new product line that appeals to more customers, the Company reduces its heavy reliance on its major customer. This reduced customer concentration cuts the Company's weighted average cost of capital capitalization rate from 10% to 9.5%. When the forecasted return of $1.2 million is capitalized at 9.5%, company value is increased by $.63 million.

Conclusion: ROI can be enhanced through any combination of reduced investment, improved returns or lower risk. Wise shareholders constantly pursue strategies to achieve these value enhancements. These shareholders also should recognize that a primary– if not the most important– contribution of a company's board and senior management is to devise and execute successful strategies to enhance ROI. These strategies should be presented and reviewed annually as the centerpiece of the company's strategic planning process.

How Debt Financing Affects ROI

What are the pros and cons of financing with varying levels of debt, and how do investors determine the optimum level? Describing debt financing as "financial leverage" is really quite accurate because the *debt funds enable the owners to lever or increase the return they earn on their equity*. The rub, however, is that *the leverage effect can also lower the investors' return*. Exhibit 7 illustrates how debt can affect rates of return on equity.

Investors should draw several conclusions from a review of the results shown in Exhibit 7:

- Because the interest cost of debt is fixed, it must be paid regardless of earnings levels and when earnings are low, the interest expense limits or even can eliminate the return to equity.
- Because the interest cost of debt is fixed, when earnings are strong, the equity holders collect all of the increased earnings; the creditors get none of it.
- The lower risk, lower return nature of debt forces creditors (bankers, primarily for private companies) to focus on collateral and cash flow. They must protect their limited return on the downside, because they get no share of the added return on the upside.

As shown in Exhibit 7, the degree of financial leverage also creates *volatility* in equity returns. When earnings varied from $800,000 to $2,400,000 under the lower leverage of capital structure A, the resulting earnings per share ranged from $4.80 per share at an EBIT of $800,000 to $14.40 per share at an EBIT of $2,400,000. With the higher debt in capital structure C, however, earnings per share varied much more, from $3.00 to $27.00 over the same range of EBIT.

This volatility, which is portrayed graphically in Exhibit 8, clearly illustrates both the risks and rewards of financial leverage. And it emphasizes to private company owners the critical need to clearly understand your company's competitive position. The stronger your long-term position appears to be, the more stable your resulting earnings and cash flows should be which enable you to take greater advantage of debt financing. A less certain or weaker ability to compete requires safer financing with less debt.

Higher growth companies frequently need capital for expan-

Higher growth companies frequently need capital for expansion, and their owners can benefit from the many choices of funding that the market offers. In addition to traditional debt, there are sources of subordinated debt and hybrid debt/equity funds that offer risk/reward combinations to fit almost any need. Whether an investor class wants a minimum level of fixed returns, protection on the downside, potential on the upside, or incentives to management to share in stock value enhancement, financing mechanisms exist. Each offers different levels of risk and return to match an individual investor's circumstances, considering the company's financing capabilities.

These financing options are also very beneficial when private companies have owners with major differences in their age, wealth, liquidity, desire for corporate control, and appetite for risk. Such owners are not limited to a "one size fits all" capital structure. A blended structure can meet multiple needs, and this structure can be changed to fit changing investor circumstances and needs.

This is often critically important for investors nearing retirement who should reduce their private company investment to decrease their risk, and increase both their portfolio diversification and their liquidity.

The message here should be clear. *Private company owners should review their capital structure annually, as well as before any major capital expenditure, refinancing or ownership change is contemplated. With a clear understanding of the risk/reward consequences of creative financing, owners can both increase their ROI and better achieve their other financial goals in the process.*

Discussion Questions on ROI Fundamentals

1. **Do investors in public companies also focus on net cash flow to invested capital in computing ROI?** Professional public company investors and managers focus primarily on net cash flow to equity, which is the return they actually receive. It consists of dividends and appreciation in stock value. Because public company investors generally cannot influence the company's capital structure and its level of debt, they focus on cash flow

Investors are considering three capital structures, A, B, and C, to provide $10 million of capital for their company. Assuming an interest cost of 10%, an income tax rate of 40%, and a stock price of $1,000 per share, note how the earnings per share (EPS) varies with the capital structures at the three different levels of earnings before interest and taxes (EBIT).

EXHIBIT 7

Balance Sheet (000)

Assets		**Liabilities and Equity**			
		Capital Structure	A	B	C
		Interest Bearing Debt	0	3,000	6,000
		Equity	10,000	7,000	4,000
Total	10,000	Total	10,000	10,000	10,000

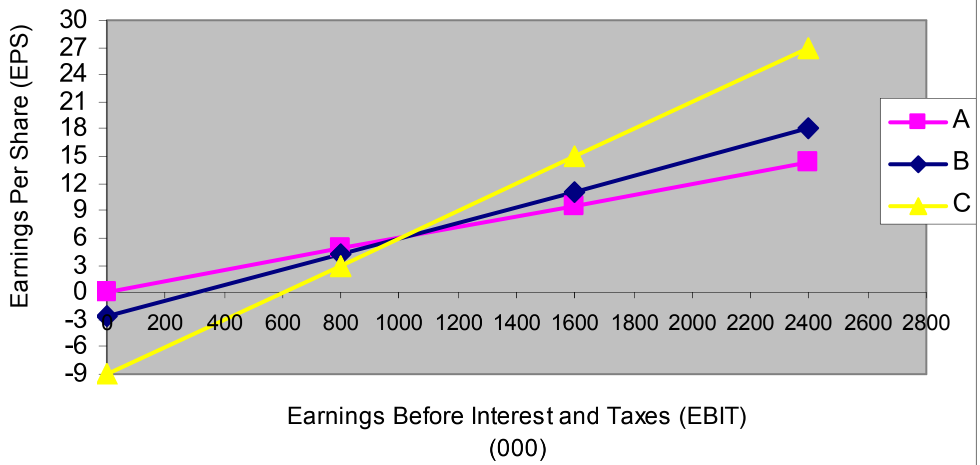
Calculation of Earnings Per Share With Different Capital Structures at Different Levels of Earnings (000) except Earnings Per Share

Capital Structure	A	B	C	A	B	C	A	B	C
EBIT	800	800	800	1600	1600	1600	2400	2400	2400
Interest Expense (10%)	0	300	600	0	300	600	0	300	600
EBT	800	500	200	1600	1300	1000	2400	2100	1800
Income Tax Expense (40%)	320	200	80	640	520	400	960	840	720
Net Income	480	350	120	960	780	600	1440	1260	1080
Number of Shares	100	70	40	100	70	40	100	70	40
EPS	4.80	4.29	3.00	9.60	11.14	15.00	14.40	18.00	27.00

(Continued from page 9)

EXHIBIT 8

Increased Volatility in Earnings Per Share Created by Variation in Amount of Financial Leverage



after borrowing rather than net cash flow to invested capital, which is before borrowing.

2. **In valuing a company, how is the company's discount rate or rate of return determined?** The discount rate reflects risk or the likelihood of achievement of forecasted returns. It reflects the company's competitive position, including general economic and industry conditions and the company's internal strengths and weaknesses. Determining this rate is a complex process that takes substantial training and experience.
3. **How does a company's actual performance versus expectations affect value?** As this article has explained, anticipated future profits, if they are adequate, and the likelihood of achieving them determine a company's value. *When a company's actual performance is above or below anticipated performance, investors use this new information to determine their new expectations and ultimately the value of the company's stock. So investors continually monitor a company's historical performance, but generally make their investment decisions based on anticipated future performance.* This same continual process of assessing actual versus anticipated performance occurs with public companies where actual profits are always compared against the level that was expected.
4. **Does a key change in a company's competitive position, such as a breakthrough in technology, the emergence of a new strong competitor, or the loss of a key person, affect value? When does such a change occur?** The value of publicly traded stock moves up and down every day based on changing competitive factors and the same thing actually occurs with private companies. It simply is noticed much less, or not at all, because the value of private companies is generally not monitored on a regular basis. Changes in stock value for public and private companies occur as soon as investors are aware of new competitive information.
5. **When should shareholders focus on a company's value to a strategic buyer versus its fair market value?** *Shareholders are wise to always monitor the interest strategic buyers may have in their company and the price buyers would pay based on synergies they believe they could achieve through an acquisition.* Shareholders should pay particular attention to the level of interest expressed by strategic buyers when they believe their company's strategic position, and therefore its competitive advantages, are about to decline. At that time, strategic buyers may be able to overcome this weakness and pay an attractive price to do so.
6. **Since a lower cost of capital, which reflects lower risk, generates a higher value, can investors create value by increasing debt to lower their company's cost of capital or WACC?** While this makes theoretical sense, it fails a reality check. Value is a function of what the market will pay for an asset and a property's current capital structure is generally of little interest to buyers because buyers brings their own capital. Thus, buyers could independently bring the benefits of financial leverage that debt creates, so buyers should not be expected to pay any premium to the seller for the debt financing the seller possesses. *While debt financing cannot artificially raise a company's value, it can increase investor's ROI as this article has explained.*

Connecting Financial Metrics to Value Drivers

Exhibit 6 presents three options to improve ROI by focusing on the key metrics of investment, net cash flow and rate of return. Investors and managers must recognize, however, that these metrics reflect the results of activities in functional operating areas of the business that drive the company's performance and value. *Thus, successful strategy must link improvement of the key ROI metrics to performance, efficiency and effectiveness in these key functional areas.*

The following exhibits connects important financial statement figures to their underlying activities in the business.

EXHIBIT A
Profit Margin Value Drivers

Value Drivers	Income Statement Accounts
Markets Customers Advertising and Marketing Policy Volume Pricing Product Bundling Potential	Sales
Production Capacity Production Efficiency Product Design Raw Material Choices and Costs Labor Costs Overhead Costs and Utilization	Cost of Goods Sold
Warehousing and Distribution Costs and Efficiency Marketing, Advertising, and Selling Costs General Administration Policies and Costs	Operating Expenses
Attributes Strategies Rates	Income Taxes

EXHIBIT B
Asset Turnover Value Drivers

Value Drivers	Balance Sheet Accounts
Customer Base Industry Practices Credit Policy Collection Procedures Discounts and Allowances Credit Loss Exposure	Accounts Receivable and Collection Period
Supplier Capabilities Purchasing versus Handling versus Carrying Costs Customer Loyalty and Stock Out Risks Production Requirements Distribution Capabilities Obsolescence Threats	Inventory and Turnover
Supplier Base and Purchasing Power Industry Practices Payment Policy Cash Flow Capacity Discounts and Allowances Credit Availability	Accounts Payable, Accrued Payables, and Payment Period
Current and Anticipated Capacity Production and Scheduling Efficiency Warehousing and Distribution Efficiency Capital Constraints Vendor/Supplier Capacity and Reliability Make or Buy Options	Fixed Assets and Turnover

Source for Exhibits A & B: *VALUATION FOR M&A: Building Value in Private Companies* by Frank C. Evans and David M. Bishop, published by John Wiley & Sons

Conclusion

The message here is that achievement of improved profit margins, asset utilization and cash flow results from improved execution in these operations. Holding managers accountable for performance of these activities will yield results on the financial statements and in the investors' ROI.

Summary

Private company owners and executives should focus everyday on maximizing shareholder value and ROI just as public companies do. Lack of sound information and processes is no longer justification for not driving and accurately tracking investor returns. If you seriously want to build long-term value in your private company, call us to implement this process for your investors.

EVANS AND ASSOCIATES

VALUATION ADVISORY SERVICES

P.O. Box 655
One East State Street
Sharon, PA 16146

Phone: 724-346-0150 Fax: 724-342-4510

Visit us on the Web!
www.evansandassociates.net

Frank C. Evans
ASA, CBA, CPA/ABV
fevans@evansandassociates.net

Our Mission

Evans and Associates is a leading provider of strategic valuation advisory services. We maximize wealth and profits for individuals and corporations. When your circumstances require measurement or management of business value, our focused approach provides solutions. Our team's expertise in competitive analysis, finance and accounting, merger and acquisition, risk analysis and value creation forms the basis for our opinions and advice.

Typical engagements for Evans and Associates include specialized valuation consultation for the purpose of gift or estate planning, merger and acquisition, shareholder value enhancement and litigation support.

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Personal Attention Backed by a Network of National Resources

Evans and Associates is a specialized valuation advisory firm small enough to provide the personal attention you want, but deep enough to possess the broad range of service expertise you may need. Our membership in the American Business Appraisers (ABA) National Network– we were the founding affiliate member—provides resources and advice from other nationally known valuation experts. Our ABA affiliation enables us to effectively execute virtually any valuation or merger and acquisition assignment.